Supreme Court, U. S.
FILED
JUL 26 1978
MICHAEL RODAK, JR., CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

Fall Term, 1978

No. 77-1410

William E. Butner, Petitioner,

vs.

United States, et al., Respondents.

On Writ of Certiorari to the United States
Court of Appeals for the Fourth Circuit

Petition for Certiorari Filed April 4, 1978
Certiorari Granted June 12, 1978

BRIEF FOR THE PETITIONER

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BRIEF FOR THE PETITIONER

OPINIONS BELOW

The United States Bankruptcy Court sitting in Charlotte, North Carolina, on July 1, 1976, declared the Petitioner to be an unsecured creditor with respect to the rents derived from the encumbered property during bankruptcy. The order of the Bankruptcy Court [App. to Pet. for Cert. pp. 2a-20a] is unreported. The opinion of the United States District Court for the Western District of North Carolina, Statesville Division, reversing and vacating the decision of the Bankruptcy Court [App. to Pet. for Cert. pp. 21a-30a] is unreported. The majority opinion of the United States Court of Appeals for the Fourth Circuit, reversing the judgment of the District Court [App. to Pet. for Cert. pp. 31a-43a] is reported at 566 F.2d 1207 (1977).

JURISDICTION

The judgment of the Court of Appeals for the Fourth Circuit was made and entered on December 8, 1977. (App. to Pet. for Cert. pp. 31a-43a) The petition of William E. Butner for a rehearing was denied on January 6, 1978. (App. to Pet. for Cert. p. 44a) The motion of William E. Butner for a stay of mandate pending the filing of a petition for Writ of Certiorari was denied on January 16, 1978. (App. to Pet. for Cert. p. 45a) The petition for a writ of certiorari was docketed on April 4, 1978, and granted on June 12, 1978. The jurisdiction of this Court is invoked under 11 U.S.C. §47(c) and 28 U.S.C. §1254(1).

CONSTITUTIONAL PROVISIONS, STATUTES AND RULES INVOLVED

United States Constitution, Article I §8, vol. 1 U.S.C., p. XLVII

The Congress shall have power***

Clause 4. To establish an uniform Rule of Naturaliza-

tion, and uniform laws on the subject of Bankruptcies throughout the United States;

11 U.S.C. §752, p. 1248

Where not inconsistent with the provisions of this chapter, the rights, duties, and liabilities of creditors and of all other persons with respect to the property of the debtor shall be the same, where a petition is filed under section 721 of this title and a decree of adjudication has not been entered in the pending bankruptcy proceeding, as if a decree of adjudication had been entered in such bankruptcy proceeding at the time the petition under this chapter was filed, or, where a petition is filed under section 722 of this title, as if a voluntary petition for adjudication in bankruptcy had been filed and a decree of adjudication had been entered at the time the petition under this chapter was filed.

11 U.S.C. §776(2), p. 1252

If the statement of the executory contracts and the

schedules and statement of affairs, as provided by paragraph (1) of section 724 of this title, are not duly filed, or if an arrangement is not proposed in the manner and within the time fixed by the court, or if an arrangement is withdrawn or abandoned prior to its acceptance, or is not accepted at the meeting of creditors or within such further time as the court may fix, or if the money or other consideration required to be deposited is not deposited or the application for confirmation is not filed within the time fixed by the court, or if confirmation of the arrangement is refused, the court shall--

***

(2) where the petition was filed under section 722 of this title, enter an order, upon hearing after notice to the debtor, the creditors, and such other persons as the court may direct, either adjudging the debtor a bankrupt and directing that bankruptcy be proceeded with pursuant to the provisions of this title or dismiss-

ing the proceeding under this chapter, whichever in the opinion of the court may be in the interest of the creditors: Provided, however That an order adjudging the debtor a bankrupt may be entered without such hearing upon the debtor's consent.

11 U.S.C. §778, pp. 1252-1253

(a) Upon the entry of an order directing that bankruptcy be proceeded with--

***

(2) in the case of a petition filed under section 722 of this title, the proceeding shall be conducted, so far as possible, in the same manner and with like effect as if a voluntary petition for adjudication in bankruptcy had been filed and a decree of adjudication had been entered on the day when the petition under this chapter was filed; and the trustee nominated by creditors under this chapter shall be appointed by the court, or, if not so nominated or if the trustee so nominated fails to qualify within five days after notice to him of the

entry of such order, a trustee shall be appointed by the court;

***

N. C. Gen. Stat. §1-502(1)

A receiver may be appointed,

(1) Before judgment on the application of either party, when he establishes an apparent right to property which is the subject of the action and in the possession of an adverse party, and the property or its rents and profits are in danger of being lost, or materially injured or impaired; except in cases where judgment upon failure to answer may be had on application to the court.

28 U.S.C. Appendix--Rule of the Supreme Court 19(1)(b), p. 7686

1. A review on writ of certiorari is not a matter of right, but of sound judicial discretion, and will be granted only where there are special and important reasons therefor. The following, while neither con-

trolling nor fully measuring the court's discretion, indicate the character of reasons which will be considered:

***

(b) Where a court of appeals has rendered a decision in conflict with the decision of another court of appeals on the same matter; or has decided an important state or territorial question in a way in conflict with applicable state or territorial law; or has decided an important question of federal law which has not been, but should be, settled by this court; or has decided a federal question in a way in conflict with applicable decisions of this court; or has so far departed from the accepted and usual course of judicial proceedings, or so far sanctioned such a departure by a lower court, as to call for an exercise of this court's power of supervision.

11 U.S.C. Appendix-Bankruptcy Rule 201(a), p. 1304

Purposes and Term of Receivership. Subject to the

provisions of this rule, the court may appoint a receiver when necessary in the best interest of the estate (1) to take charge of the property of a bankrupt; (2) to conduct the business of the bankrupt; or (3) to afford representation to the estate in an action, adversary proceeding, or contested matter when no trustee has qualified or the interest of the trustee may be adverse to that of the estate. Such appointment shall be terminated when the trustee qualifies or there is no further need for a receiver, and the authorization to conduct the business of the bankrupt after adjudication shall continue only for such time as may be in the best interest of the estate and consistent with orderly liquidation.

11 U.S.C., Appendix-Bankruptcy Rule 601(e), p. 1335

(e) Availability of Other Relief. Nothing in this rule precludes the issuance of, or relief from, any stay, restraining order, or injunction when otherwise authorized.

11 U.S.C. Appendix-Bankruptcy Rule 701, p. 1340

The rules of this Part VII govern any proceeding instituted by a party before a bankruptcy judge to (1) recover money or property, other than a proceeding under Rule 220 or Rule 604, (2) determine the validity, priority, or extent of a lien or other interest in property, (3) to sell property free of a lien or other interest for which the holder can be compelled to take a money satisfaction, (4) object to or revoke a discharge, (5) obtain an injunction, (6) obtain relief from a stay as provided in Rule 401 or 601, or (7) determine the dischargeability of a debt. Such a proceeding shall be known as an adversary proceeding.

QUESTIONS PRESENTED

I. Does the split among the circuits on the question of the necessary prerequisites before a mortgagee can reach the rents of encumbered property to satisfy a deficiency violate Article I, Section 8, Clause 4 of the United States Constitution?

II. Should a mortgageholder in a Bankruptcy situation be required to make preliminary attempts to obtain possession of the property or to perform actions which substitute for possesion before he can reach rents of encumbered property to satisfy a deficiency?

III. Did petitioner satisfy the requirements of the Fourth, Eighth and Ninth Circuits by obtaining the appointment of a receiver?

IV. Did the Fourth Circuit Court of Appeals commit error in holding actions performed during a Chapter XI proceeding were not performed "during bankruptcy?"

V. If a Chapter XI proceeding is not a part of bankruptcy, did Petitioner establish his right to the rents by obtaining the appointment of a receiver before bankruptcy?

VI. In its opinion in this case did the Fourth Circuit Court of Appeals so far depart from the accepted and usual course of judicial proceedings as to call for an exercise of the Supreme Court's supervisory power?

STATEMENT OF THE CASE

William E. Butner, Robert L. McKaughn, Jr., and Jack Sipe Construction Company held a second mortgage in the amount of $360,000.00 on real property owned by Golden Enterprises, Inc., a North Carolina corporation. Since that time Robert L. McKaughn, Jr., and Jack Sipe Construction Company have assigned all of their right, title and interest in the indebtedness and deeds of trust to William E. Butner, the Petitioner herein, thus making him the sole second mortgageholder.

On May 4, 1973, Golden Enterprises, Inc., filed a petition in bankruptcy for an arrangement under Chapter XI of the Bankruptcy Act, 11 U.S.C. Section 701, et seq. While the Chapter XI proceeding was pending, on April 7, 1974, upon motion by William E. Butner, Robert L. McKaughn, Jr., and Jack Sipe Construction Company to secure the debt to them in the amount of $360,000.00, and upon their agreement

that they would not attempt to foreclose their deed of trust without Court approval, the Honorable Joseph R. Cruciani, Bankruptcy Judge, ordered that the note and deed of trust to them from Golden Enterprises, Inc., should be in the original amount of $360,000.00, reduced the rate of interest from twelve percent to ten percent per annum and further ordered "That the holders of the note or any assignee thereof shall not attempt to file a petition to reclaim or to foreclose except upon motion to this Court setting forth the reasons therefore." (App. p. 196a)

On April 17, 1974, the first and second mortgageholders sought the appointment of an agent to collect the rental income from Golden Enterprises' property. (App. pp. 202a-203a) On April 18, 1974, the Honorable Joseph R. Cruciani, Bankruptcy Judge, appointed Simon Joseph Golden as agent "to receive all income derived from debtor's real estate" and to apply that income to the payment of interest and principal on the

second mortgage as well as to other enumerated debts of the corporation. (App. pp. 204a-206a)

A plan of arrangement was never confirmed, and on February 14, 1975, Golden Enterprises, Inc., was adjudged a bankrupt, and the Honorable Joseph R. Cruciani appointed Joe N. Cagle as Trustee to take charge of the real estate and "to collect and receive all rents, issues, income and profits . . . due or to become due to the within estate, and to hold and retain all monies thus received to the end that the same may be applied under this or different or further orders of this Court . . . ." (App. pp. 342a-343a)

The first mortgage payments had been kept current during the Chapter XI proceeding, but in February, 1975, the Trustee ceased making payments on the first mortgages, allegedly pursuant to an oral order issuing from someone in the office of the Bankruptcy Judge, although there is no direct evidence that any such further order was entered.

There now remains in the Trustee's hands approximately $162,971.32, all of which is rental income from the real property since the personal property was disposed of during the Chapter XI proceeding and its proceeds paid out to other creditors.

During the Bankruptcy proceeding, the second mortgageholder orally sought abandonment of the property to him. The Bankruptcy Judge gave repeated oral assurances to the second mortgageholder that, if, when the property was sold, the sale did not bring enough money to pay the first and second mortgage debts, he would not confirm the sale but would abandon the property. In the meantime, the Judge refused to abandon the property. At the first meeting of the creditors, the trustee suggested abandonment to the second mortgageholder and the second mortgageholder also urged this course of action. (App. pp. 384a, 390a-391a) The Judge indicated that he would abandon the property if the sale proceeds were in-

sufficient to pay the mortgage debts [App. p. 388a] and indicated in addition that he was refusing to abandon the real estate because of his concern over how the costs of administration would be paid. (App. pp. 391a, 399a-400a)

The real estate was sold at public auction on July 28, 1975, and the sale of two of the tracts was confirmed. William E. Butner appealed to the United States District Court for the Western District of North Carolina, Statesville Division.

After hearing the appeal, the Honorable Woodrow W. Jones, Judge, on November 7, 1975, ordered the Trustee to resell the real estate at public auction free and clear of all liens and encumbrances except the first deeds of trust thereon. Judge Jones further ordered that the second mortgageholder be allowed to use the outstanding principal balance of his Deed of Trust to bid at the bankruptcy resale.

At the resale, November 12, 1975, William E. Butner

became the last and highest bidder for the property, with a bid of $174,000.00, thus leaving a balance due on his note of $186,000.00. However, at the final meeting of creditors to determine the distribution of the $162,971.32 in rents held by the Trustee, the Honorable Marvin R. Wooten, Bankruptcy Judge, declared the second mortgageholder a general creditor with respect to the balance due on his note while awarding, almost without exception, all claims arising during the Chapter XI proceeding as priority claims. (App. to Pet. for Cert., pp. 2a-20a)

William E. Butner appealed this order to the United States District Court for the Western District of North Carolina, Statesville Division, where the Honorable Woodrow W. Jones, Chief Judge, reversed and vacated the Bankruptcy Judge's finding of William E. Butner's unsecured status as to the rents derived from the encumbered property. (App. to Pet. for Cert., pp. 21a-30a) From this order the United States and the Trustee,

et al. appealed to the United States Court of Appeals for the Fourth Circuit where the United States' appeal on its tax claim was consolidated with the appeal of the Trustee, et al. for briefing and argument. The appeal was heard on October 4, 1977, and on December 8, 1977, the Fourth Circuit Court of Appeals, Senior Circuit Judge Bryan dissenting, reversed the judgment of the United States District Court and remanded the case for compliance with the final order of Judge Wooten. (App. to Pet. for Cert. pp. 31a-42a) William E. Butner's petition for a rehearing was denied on January 6, 1978, [App. to Pet. for Cert. p. 43a] and his motion for a stay of mandate pending petition for writ of certiorari to the United States Supreme Court was denied on January 16, 1978. (App. to Pet. for Cert. p. 44a) William E. Butner petitioned the United States Supreme Court for a writ of certiorari on March 28, 1978, and certiorari was granted on June 12, 1978.

SUMMARY OF ARGUMENT

I.

There is a split of authority among the Federal courts on the question of what a mortgageholder in a bankruptcy situation has to do to reach the rents from the encumbered property in order to satisfy a deficiency. Some circuits, notably the Third and Seventh, say the mortgageholder can reach those rents as a matter of course. Other circuits, including the Eighth and Ninth, say that the mortgagee must first have taken actual possession of the encumbered property or, if bankruptcy prevents, this, he must perform an act equivalent to taking possession such as obtaining a sequestration order or the appointment of a receiver to collect the rents. In the instant case, the Fourth Circuit aligned itself with the Eighth and Ninth Circuits saying that this position would lead to a result which was most consistent with the result under state law.

Petitioner submits that this split in authority violates Article I, Section 8 of the United States Constitution which provides for a uniform law of bankruptcy. The rule in this area is that federal courts will apply state law whenever it does not conflict with the federal bankruptcy law, but if there is a conflict, the federal law prevails. Stellwagen v. Clum, 38 S.Ct. 215, 245 U.S. 605, 62 L.Ed. 507 (1918). Petitioner submits that bankruptcy, by its very nature, interferes with the state-law mortgage relationship to such an extent that it destroys the relationship and that, being in conflict with the federal law, the State law is preempted in this area. Thus the federal law controls the question, and the difference in its application by the various circuits amounts to a non-uniform law of bankruptcy which is unconstitutional. The Supreme Court should state the proper rule to be followed to dispose of the present unconstitutional split of opinion.

II.

Petitioner submits that the better rule is that adopted by the Third and Seventh Circuits. In this kind of situation a mortgageholder should be able to reach the rents of encumbered property to satisfy a deficiency without the preliminary attempts to take possession or any actions which substitute for taking possession. The policy behind the requirement of taking possession is that doing so would stop any mismanagement of the property by the debtor which might be adversely affecting its value and would keep the deficiency from mounting. This policy is inapplicable in bankruptcy when the property is under the control and supervision of the court especially when, as in the instant case, the decline in value of the property securing the mortgage resulted in part from actions of the bankruptcy court with respect to the property.

The rule adopted by the Fourth, Eighth and Ninth Circuits furthers the games-playing theory of litigation

by stressing form over substance and may unfairly defeat a secured creditor's right to have his claim paid if the creditor is not aware of the technical rules of the particular jurisdiction with respect to claiming rents.

In addition the rule also discounts the fact that one of the prime considerations of a lender is the income-producing capacity of the property intended to secure the loan. Given the importance of the income in deciding whether to loan, it is unfair then to deny the lender access to the income to satisfy his claim.

III.

Even if the Court decides that the rule of the Fourth, Eighth and Ninth Circuits is the proper rule, Petitioner did enough to secure his claim to the rents under that rule by obtaining the appointment of a receiver during the Chapter XI proceeding, and thereafter he was not obliged to take further action to the same end.

IV.

The Fourth Circuit Court of Appeals in the instant

case held that petitioner's obtaining appointment of a receiver during the Chapter XI proceeding did not establish his right to the rents because it was not done "during bankruptcy" thus ruling sub silentio that Chapter XI proceedings are not a part of bankruptcy. Petitioner submits that this is error and points out the many carryovers in the bankruptcy act itself including the identical nature of the rights, duties and liabilities of creditors in Chapter XI and bankruptcy proceedings, the provisions for conversion and the relation back of the adjudication of bankruptcy in cases of conversion to the date the Chapter XI petition was filed. Petitioner points out factual connections between the two proceedings here, including the carryover effect of the order appointing the Trustee and the fact that all the parties and the supervising Bankruptcy Judge were the same in both, and submits that the two proceedings are on a continuum with each other within one overall scheme which is "bankruptcy." Further Petitioner

points out that the effectiveness of the Chapter XI receivership order did not have to carry over to the straight bankruptcy proceeding, for the thing which establishes his rights here is the act of having had the receiver appointed in the first place.

V.

According to Volume 4A of Collier on Bankruptcy [¶ 70.16 at 159-161 (1976)] and the Eighth and Tenth Circuits, securing the appointment of a receiver before bankruptcy also gives the mortgageholder the right to the rents if such an action is acceptable under state law. N. C. Gen. Stat. § 1-502(1) authorizes the appointment of a receiver in a situation such as the one encountered by the second mortgageholder here. Thus if the Fourth Circuit is right in holding Chapter XI proceedings are not part of bankruptcy, then Petitioner's actions during the Chapter XI proceeding were performed before bankruptcy, and he is entitled to the rents.

VI.

The Fourth Circuit's opinion rules on one hand that Petitioner is not entitled to the rents because his actions to secure them took place during Chapter XI proceedings which are not a part of bankruptcy. On the other hand, it reinstated the order of the Bankruptcy Judge below which awarded as priority claims attorney and accountant's fees generated by work done during Chapter XI. If Chapter XI actions are not part of bankruptcy where Petitioner is concerned, they cannot be part of bankruptcy where the attorneys and accountants are concerned. This inconsistency is such as to require the Supreme Court to exercise its supervisory power over the lower federal courts to resolve it.

ARGUMENT

I. <u>The split among the circuits on the question of the necessary prerequisites for a mortgageholder's reaching the rents of the encumbered property to satisfy a deficiency violates Article I, Section 8,</u>

Clause 4 of the United States Constitution and thus the split should be resolved by the Supreme Court.

In the United States today, state laws espouse one of three theories on the nature of a mortgage transaction. In most cases these theoretical differences do not cause any difference in result; however, in one area the mortgage theory of the particular jurisdiction is important. "In a few states, known as title states, the mortgagee has the continuing right to possession, as he does in England. In one or two other states, known as 'hybrid' or 'intermediate' theory states, the mortgagee is entitled automatically to possession immediately upon default. Everywhere else, the mortgagee must petition the court for the right to take possession--via a court appointed receiver--to protect the security from waste or dissipation of the rents; usually the petition is received and granted as part of a foreclosure proceeding." A. Axelrod, C. Berger and Q. Johnstone, Land Transfer and Finance Cases and Materials,

138, n. 23 (1971). The right of the mortgagee to reach the rents of the mortgaged property arises from his possession of the property and thus is affected by the mortgage theory of the particular jurisdiction. Under North Carolina law the mortgagor is entitled to the rents of the encumbered property, even after default, until the mortgagee takes possession of the property. Gregg v. Williamson, 246 N.C. 356, 98 S.E. 2d 481 (1957). Therefore, normally, in North Carolina when a mortgagor defaults, the mortgagee sues to foreclose the mortgage, obtains possession of the property and thus is able to reach the rents of the encumbered property.

However, if the mortgagor files a petition in bankruptcy and the Bankruptcy Court issues a stay of all foreclosure proceedings, the mortgagee is cut off from his remedy under state law. If the ensuing bankruptcy sale of the land does not generate enough money to pay the mortgage, then the bankruptcy courts will allow

the mortgageholder to reach any accumulated rents attributable to the property to satisfy the deficiency. However, there is a split of authority among the Federal circuit courts as to how a mortgagee may become eligible to reach the rents to satisfy a deficiency. The Third and Seventh Circuits simply allow a secured creditor to reach the rental income. In re Pittsburg Duquesne Development Co., 482 F.2d 243, 246 (3d Cir. 1973); In re Wakey, 50 F.2d 869 (7th Cir. 1921). The Eighth and Ninth Circuits hold that the mortgagee has no right to the rents unless he has taken possession of the property. Since a mortgagee cannot take possession of property which is under the control of the bankruptcy court, these circuits allow the mortgagee to secure his right to the rentals by performing other actions as a substitute for taking possession. Tower Grove Bank & Trust Co. v. Weinstein, 119 F.2d 120 (8th Cir. 1941); In re Hotel Saint James Co., 65 F.2d 82 (9th Cir. 1933). Such actions include petitioning for a sequestration order, getting a receiver appointed to collect the rents, or obtaining the court's consent to a foreclosure. Pollack v. Sampsell, 174 F.2d 415 (9th Cir. 1949); Mortgage Loan Co. v. Livingston, 45 F.2d 28 (8th Cir. 1930); 4A Collier on Bankruptcy (14th ed.) ¶ 70.16 at 150-163 (1976). By its decision in the instant case, the Fourth Circuit Court of Appeals has aligned itself with the Eighth and Ninth Circuits, saying in its opinion that "[it] best ensures that the outcome in federal court will parallel the result that would obtain in state court had bankruptcy proceedings not been instituted." (App. to Pet. for Cert., p. 35a)

Petitioner submits that this split among the circuits as to the prerequisites for reaching rents of encumbered property to satisfy a deficiency violates Article I, Section 8, Clause 4 of the Constitution of the United States which empowers Congress "to establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." Vol. 1 U.S.C. p. XLVII.

With respect to this clause of the Constitution, this Court has stated "In view of this grant of authority to the Congress, it has been settled from an early date that state laws to the extent that they conflict with the laws of Congress, enacted under its constitutional authority, on the subject of bankruptcies are suspended. While this is true, State laws are thus suspended only to the extent of actual conflict with the system provided by the Bankruptcy Act of Congress." Stellwagen v. Clum, 38 S.Ct. 215, 217, 245 U.S. 605, 613, 62 L.Ed. 507, 511 (1918). The idea behind this suspension of state law is of course that Congress has by its bankruptcy legislation preempted certain areas of the law and has thus left no room for the operation of state law. If the state law does not conflict with the Federal law, it is not preempted. For example, in the Stellwagen case above, the Court used state law to avoid a transfer where the transferee might otherwise have had a claim under the Federal Bankruptcy law.

The Court in the Stellwagen case went on to clarify the uniformity requirement. "Notwithstanding this requirement as to uniformity, the bankruptcy acts of Congress may recognize the laws of the state in certain particulars, although such recognition may lead to different results in different states." Stellwagen v. Clum, supra. For example in this context the courts have applied state law to determine whether a mortgagee after an unconfirmed foreclosure sale has a property right with which Congress cannot interfere [U.S. National Bank of Omaha v. Pamp, 83 F.2d 493 (8th Cir. 1936)]; and to determine the time of vesting of a mortgagee's rights in the property [In re Lowman, 79 F.2d 887 (7th Cir. 1935)].

In the cases where the Court has applied state law in a Bankruptcy situation, the state law applied has had merely collateral relevance to the Court's decision and has not been directly concerned with the heart of the issue, for, in the latter situation, the Bankruptcy

law would supercede it.

Petitioner submits that, once the mortgagee is stayed from foreclosing his mortgage, the Bankruptcy law has disrupted the mortgage relationship to such an extent that it preempts the field and leaves no room for state requirements vis a vis the right to rents from encumbered property. The normal sequence of events is default, mortgagee seeking foreclosure and right to take possession, and foreclosure with the right to reach the rents. If Bankruptcy intervenes and denies the right to seek foreclosure, the sequence is completely disrupted. The Federal Courts who attempt to substitute other actions for the taking of possession are in essence trying to create state law and end up with a rule which is neither state law nor Federal law since state law requires taking possession and the Bankruptcy Act requires nothing. Deference to state law by the creation of such a rule is also unnecessary because, if Federal law prevents taking possession of the property, then there is nothing left for the state law to act upon, and since the state law is in conflict with the Federal law, it must yield as Federal law has preempted the field on that question. The state law having yielded to the federal law, any attempt by the Federal courts to give new effect to the state law is also contrary to the idea of preemption, and since not all federal circuit courts have adopted the rule, the split among the circuits with respect to this matter violates the uniformity clause in Article I, Section 8 of the United States Constitution.

In order to be uniform in this area, the Bankruptcy law cannot destroy the means of obtaining a right to the rents and leave standing the state requirement of the now-impossible act in one jurisdiction while not doing anything to affect a mortgagee's right to the rents in another jurisdiction. And in the same way, the court in a Bankruptcy situation cannot create prerequisites to obtaining rents in one jurisdiction while imposing

no such conditions in another jurisdiction.

Thus the split among the circuits here is unconstitutional and should be resolved by this Court.

II. In a Bankruptcy situation, a mortgageholder should be allowed to reach the rents of the encumbered property to satisfy a deficiency without having to make preliminary attempts to obtain possession of the property and without having to perform actions which substitute therefor.

The only time the question of allowing a mortgageholder to reach rents of the encumbered property arises is where the proceeds of the bankruptcy sale do not fully satisfy the mortgage debt thus leaving the mortgagee with a deficiency. The fact that this is a bankruptcy situation is important in demonstrating why the mortgagee should not be required to make preliminary attempts to take possession.

In a normal foreclosure action, the mortgagee could sue the mortgagor for the deficiency. However, the

fact that bankruptcy proceedings include a stay of all suits against the debtor precludes this means of relief.

Allowing a mortgagee to reach the rents from the property which secures his mortgage should not be seen as taking money away from the unsecured creditors. He has loaned money in the amount of the mortgage and taken security for the debt. If he is unable to recover the difference between his debt and the amount generated by the bankruptcy sale of the land securing it, he has lost that money, and given that a deficiency results only when the value of the security declines, he cannot be blamed and should not be penalized for the drop in value of his security in a bankruptcy situation where the existence of the bankruptcy situation has to a great extent caused the drop in value. In a bankruptcy situation, rents which might normally have been reinvested in the upkeep of the property to preserve its value are instead being held by the Court.

In the instant case, the Court allegedly ordered the Trustee to stop making payments on the first and second mortgages. These payments were stopped in February, 1975 [App. pp. 346a-352a], and, by the time the bankruptcy sale was held, the mortgages were greatly in arrears. Furthermore, the court delayed selling the property, mainly to collect enough rents to defray the costs of administration and partly in hopes that the economic situation would improve. Each month's delay threw the mortgages further in arrears. In addition the delay meant that the financial institutions holding the first mortgages were under pressure by the Federal bank examiners to get their mortgages paid as soon as possible. Thus the moment the bankruptcy sale was confirmed they wanted immediate payment of all the arrears and were not disposed to give a buyer much time to get the money together. This meant that any buyer would have to come up with large sums of cash almost immediately at a time of economic recession

with money not readily available. All of these factors, most of which arose as a result of actions of the bankruptcy court, reduced the value of the property to the point that the bankruptcy sale did not bring enough to pay the second mortgage in full.

The idea behind requiring a mortgageholder to take possession of the encumbered property before he can reach its rents to satisfy his debt is that, if the land is declining in value because it is being mismanaged by the debtor, the creditor can stop this decline by taking possession of it himself. This idea has no application in a bankruptcy situation because the Court is in possession of the land. In this case the mortgageholder tried to obtain possession of the property through abandonment at a time when the mortgages were not too badly in arrears and could have been brought up to date to stop the land from declining in value. However, he was unsuccessful in his attempts. If the actions by the Bankruptcy Court are at least partly

to blame for the decline in value of the security and the bankruptcy court refuses to grant possession of the property to the mortgageholder at a time when the decline in value can be slowed or halted, the mortgageholder should not be penalized for the decline in value by being denied access to the rents to satisfy a deficiency.

The rule adopted by the Fourth Circuit in this case furthers the games-playing approach to litigation which the courts, the Congress and the legislatures of the states have been attempting to do away with by revision of the rules of civil procedure and other statutes with an emphasis on the consideration of substance over form and on the idea that a worthy claim should not be defeated by a technical rule in a situation where the rule has no rational application. Under the rule adopted here, a creditor who has not read the fine print about the split between the circuits on this issue or whose lawyer is not highly specialized in bankruptcy law, is penalized for failing to do something

which he would not have to do if the property in which he holds a security interest were located in another state. A possible justification for applying the rule in a bankruptcy contest is that, in a situation where there are many claims and few assets, it gives an indication of the diligence with which a creditor is pursuing his claim and rewards the one who pursues his claim the most vigorously. This application of the rule is unfair. By making the effort and incurring extra expense to obtain security for his debt, a secured creditor has already indicated a diligence which is not shown by the unsecured creditors. Of course there must be enough action on the part of the creditor to make it clear that he has a claim and is not waiving it, but when the newly-adopted Fourth Circuit rule is applied, it turns the Bankruptcy proceeding into a game with all the unsecured creditors waiting to pounce on the assets if a secured creditor fails to satisfy every technical requirement along the

way and ignores the fact that his original efforts to secure his debt at its inception should entitle him to some priority.

The rule also discounts the importance of the income-producing capacity of the property in connection with the mortgage transaction. The ability to produce income is one variable in the determination of the value of a piece of property prior to taking a mortgage on it. If the property could not be rented or if no business could be operated thereon, the amount for which the property could be mortgaged would be less. In making a loan and taking a mortgage on real estate of this type, the lender looks in great measure to the income being produced by the property to see if the mortgagor can make the mortgage payments from that income. The ordinary lender does not enter into a mortgage transaction with the idea that the mortgagor will be unable to repay the loan, thus making foreclosure necessary, since foreclosure is an extreme and ex-

pensive means of obtaining satisfaction of a debt. Given that the income-producing ability of a piece of real estate is a prime consideration in the acceptance of a mortgage on that property as security for a loan, it seems only fair that a secured party be able to satisfy a claim in bankruptcy from accrued rents attributable to that property once the proceeds of the bankruptcy sale of the property have been exhausted.

III. Even if the rule adopted by the Fourth, Eighth and Ninth Circuits is the proper rule to follow in a bankruptcy situation, petitioner satisfied the requirements of that rule by obtaining the appointment of a receiver during the Chapter XI proceeding.

The Eighth and Ninth Circuit rule which the Fourth Circuit adopted in the instant case requires a court to consider four factors in determining whether a mortgagee has established a right to the rental income from the encumbered property: (1) the nature of the mortgage transaction under applicable state law; (2)

the terms of the mortgage itself; (3) the acts of the parties thereunder and (4) whether equitable considerations as applied by the Federal Bankruptcy Court may alter the result. 4A Collier on Bankruptcy, (14th ed.) ¶ 70.16 at 157 (1976).

Petitioner submits that the state law of mortgages on this question is not applicable in a bankruptcy situation as more fully discussed in Argument I above. However, the law of North Carolina, if applicable, provides that the mortgagor is entitled to rents of encumbered property after default until the mortgagee takes possession of the property. Gregg v. Williamson, 246 N.C. 356, 98 S.E. 2d 481 (1957). The terms of the mortgage in this case do not address the issue of the right to the rents and thus provide no assistance in its resolution.

With regard to the actions of the parties, petitioner could not take possession of the property prior to the institution of the Chapter XI proceeding because

his mortgage was not then in default. It remained current up to the time when the Bankruptcy Judge confirmed the amount of the second mortgagees' claim and ordered "That the holders of the note or any assignee thereof shall not attempt to file a petition to reclaim or to foreclose except upon motion to this Court setting forth the reasons therefor." (App. p. 196a)

Thereafter, when the debtor did not make one of the required monthly interest payments on the second mortgage, the mortgagee had to perform one of the actions which are allowed by the Eighth and Ninth Circuits to substitute for taking possession: petitioning for a sequestration order, getting a receiver appointed to collect the rents or obtaining the court's consent to a foreclosure. Pollack v. Sampsell, 174 F.2d 415 (9th Cir. 1949); Mortgage Loan Co. v. Livingston, 45 F.2d 28 (8th Cir. 1930); 4A Collier on Bankruptcy (14th ed.) ¶70.16 at 150-163 (1976). The second mortgageholders, together with the first mortgage-

holders sought and obtained the appointment of an agent to collect the rental income from Golden Enterprises' property. (App. pp. 202a-203a) The agent was ordered "to receive all income derived from debtor's real estate" and to apply that income to the payment of certain enumerated debts including the payment of interest and principal on the second mortgage. (App. pp. 204a-206a) Having done this they had satisfied the requirements of the rule and were not thereafter required to perform other actions to the same end.

The Trustee et al. maintain that petitioner should have filed an adversary proceeding to recover the property on which he held a mortgage. They also cite, as an indication that petitioner was not claiming the rents, petitioner's failure to file answer to an adversary proceeding filed by the Trustee for authority to sell the property free and clear of liens.

Petitioner submits that, having secured the appoint-

ment of a receiver he was not required to perform additional acts to establish his claim to the rents. Bankruptcy Rule 701, which deals with adversary proceedings, indicates itself that an adversary proceeding is not the sole method of relief in this situation. At first glance three subdivisions of Rule 701 seem to apply. An adversary proceeding may be instituted "(1) to recover money or property, *** (2) determine the *** extent of a lien, (6) obtain relief from a stay as provided in Rule *** 601 ***." 11 U.S.C. Appendix-Bankruptcy Rule 701, p. 1340. The advisory committee's note on the rule indicates that subdivision (1) applies to the avoidance of transfers by the bankrupt, such as voidable preferences, transfers in fraud of creditors within four months of bankruptcy and also to a secured party's reclamation of property where he was already in actual possession at the time bankruptcy proceedings were instituted.

According to Black's Law Dictionary, "extent" means

"amount," and thus the phrase "extent of a lien" in subdivision (2) refers only to the amount of a lien and not to the sources from which it may be satisfied. Black's Law Dictionary 694 (4th ed. 1968).

The applicable section of Rule 701 in this case is (6), "to obtain relief from a stay as provided in Rule *** 601 ***." However Bankruptcy Rule 601(e) provides "Nothing in this rule precludes the issuance of, or relief from, any stay *** when otherwise authorized." 11 U.S.C. Appendix-Bankruptcy Rule 601, p. 1335. The advisory committee's note explains with respect to Rule 601(e), "The stay provided by this rule is in no way a limitation on the discretion and power of the court of bankruptcy under § 2a(15) of the Act to grant or deny or modify relief in the nature of an injunction." 11 U.S.C. Appendix-Bankruptcy Rule 601, Advisory Committee's Note, p. 1336. The second mortgageholders were under a court order not to attempt to reclaim or foreclose on their own.

Petitioner on several occasions did orally request the court to abandon the property to the second mortgageholders.

Petitioner does not necessarily argue that oral requests for abandonment were sufficient to establish his rights, for he submits those rights were already established when the receiver was appointed. However, the law does not require a useless act so he does argue that under the wording of Bankruptcy Rules 701 and 601 and the explanatory notes associated with each rule, his right to the rents was not destroyed by his failure to file an adversary proceeding.

As mentioned above the second mortgageholders had orally requested abandonment of the property to them several times. The bankruptcy judge indicate to them that, if the bankruptcy sale did not bring enough money to satisfy the second mortgage, he would abandon the property to the second mortgagees. There is only one instance when the request and reply

are a matter of record. At the first meeting of creditors, the Trustee suggested that the Court consider abandoning the property to the second mortgageholders. (App. p. 384a) Petitioner Butner joined in the suggestion, encouraging the Court to use its equitable powers to abandon the property to the second mortgageholders at the earliest possible time. (App. p. 390a-391a) The judge indicated that his hesitancy to abandon the property was due to a concern over how the administration expenses would be paid if he did so. (App. pp. 391a, 399a-400a) However the judge indicated that if the real estate sale proceeds were insufficient to pay the first and second mortgages, he would abandon the property to the mortgage holders. (App. p. 388a) The second mortgagee was relying on these comments by the judge both in the first meeting of creditors and on other occasions. Thus he had no reason either to attempt to file an adversary proceeding of his own or to answer the adversary proceeding

which the Trustee filed to obtain the authority to sell the land. The Trustee wanted to sell and the second mortgagee also wanted the sale since he had reason to believe that either the sale would bring enough to pay his claim or the sale would not be confirmed and the property would be abandoned to him.

The Trustee et al. argued below that equitable considerations should bar Petitioner from reaching the rents here because he sold one of the pieces of property obtained at the Bankruptcy Resale for one million dollars. The Court of Appeals for the Fourth Circuit apparently relied on this argument to some extent in its decision below. (App. to Pet. for Cert. p. 37a) Petitioner maintained and still maintains that the question at issue was merely whether his actions had been sufficient to establish the right to reach the rents to satisfy any deficiency and not what the amount of that deficiency might be since the part of the order which was originally appealed was that which declared

him an unsecured creditor with respect to the balance of his claim. He also maintained, and still maintains, that any profit made on the later sale is not relevant to the determination of the deficiency owed. Petitioner was not the sole bidder at the bankruptcy resale; thus the final bid at the resale represents the actual value of the property encumbered by a first mortgage which was badly in arrears. Petitioner subsequently made payments on the first mortgage and eventually paid it off, thus increasing the value of the property by his own efforts. The Affidavit of the Trustee [App., p. 775a] is based purely on information contained in the public records of the county in which the property is located and in no way represents the costs incurred by the Petitioner.

IV. The Fourth Circuit of Appeals committed error in holding that actions performed during a Chapter XI proceeding were not performed "during bankruptcy."

The Fourth Circuit in its opinion said that there was no attempt made to sequester rents or have a receiver appointed "during bankruptcy" thus holding in effect that a Chapter XI proceeding is not a part of bankruptcy. (App. to Pet. for Cert. p. 36a)

When the Chapter XI proceeding was converted to a straight bankruptcy, the order appointing a Trustee provided that he was to collect and hold the rents so that they might be applied "under this, or different or further orders of this court." (emphasis supplied). (App. p. 342a-343a) Petitioner submits that this order carried over the effectiveness of the order appointing the Chapter XI receiver so that the Trustee was holding the rents at least in part for the benefit of the second mortgageholders. It is true that he was making no mortgage payments, but it does not follow that he was not holding the funds for their ultimate benefit. One of the functions of a Trustee is to collect and hold monies to satisfy the claims of those entitled

to the funds. If the second mortgagee is held to be entitled to the funds then the Trustee will have been holding them for his benefit. It should be noted that the sole asset being held by the Trustee in Bankruptcy was rents derived from the mortgaged property. Thus there is no question of commingling of funds in this case.

Petitioning for the appointment of a separate receiver in this case would have been pointless. According to Bankruptcy Rule 201(a), the only time that a receiver can be appointed after the appointment of a Trustee is to "(3) afford representation to the estate in an action, adversary proceeding or contested matter when *** the interest of the trustee may be adverse to that of the estate." 11 U.S.C. Appendix-Bankruptcy Rule 201(a), p. 1304. This section is not applicable to the situation in this case and petitioning for the appointment of a receiver would have been futile. Surely the law would not require a mortgagee to perform futile acts in order

to maintain an already-established right, especially when the Trustee is performing the collection, protection and holding functions of a receiver.

Even if the Chapter XI proceeding is held to be separate from a straight bankruptcy to the extent that actions in one do not carry over in effectiveness to the other, the later conversion to straight bankruptcy, as noted by Senior Circuit Judge Bryan in his dissent below, would not cancel the effect of the action having been performed. Here it is the action itself which establishes the claim and not the duration of its consequences. (App. to Pet. for Cert., p. 40a)

With respect to the relationship between Chapter XI and straight bankruptcy proceedings for purposes of determining if acts performed during the Chapter XI proceeding here were done "during bankruptcy," the Petitioner submits that the two proceedings are on a continuum and that "bankruptcy" encompasses the whole system rather than individual proceedings

therein. Chapter XI is physically part of the bankruptcy title of the United States Code. Rights, duties and liabilities of creditors in Chapter XI proceedings are identical to those in straight bankruptcy proceedings. 11 U.S.C. §752, p. 1248. If a Chapter XI arrangement is not confirmed, the debtor may be adjudged a bankrupt, and the court may direct that straight bankruptcy be proceeded with pursuant to the provisions of Title 11 of the United States Code. 11 U.S.C. § 776(2), p. 1252. When a Chapter XI proceeding is converted to straight bankruptcy, the proceeding is handled as if the adjudication of bankruptcy was entered when the Chapter XI petition was first filed. 11 U.S.C. 778(a)(2), pp. 1252-1253. The technical term used when a Chapter XI proceeding gives way to a straight bankruptcy proceeding is "conversion," which implies simply a change in aspect of one proceeding rather than a total end to one proceeding followed by the beginning of a new, entirely unrelated

proceeding. In this case another index of unity is that the same bankruptcy judge presided over the arrangement and the straight bankruptcy. While a Chapter XI proceeding does not always lead to a straight bankruptcy and a straight bankruptcy does not always begin as a Chapter XI proceeding, it is submitted that the two proceedings are interrelated in a larger overall scheme rather than being completely separate entities.

V. Regardless of whether a Chapter XI proceeding is part of bankruptcy in general, the Fourth Circuit Court of Appeals erred in holding that the mortgagee had not satisfied the requirements for reaching the rents.

According to Collier on Bankruptcy, as discussed above, "Once bankruptcy has begun, the mortgagee may, if he has done nothing up to that time, take the following steps to secure the rents and profits: (1) obtain from the bankruptcy court the appointment of a receiver to collect the rents for the benefit of the

mortgagee ***." 4A Collier on Bankruptcy (14th ed.) ¶ 70.16 at 161 (1976), citing as authority Tower Grove Bank & Trust Co. v. Weinstein, 119 F.2d 120 (8th Cir. 1941).

However, Collier also says "If therefore prior to bankruptcy, the mortgagee has secured possession, commenced foreclosure proceedings, secured the appointment of a receiver for the property, or has in any other manner acceptable under the mortgage and applicable state law sequestered or attached the rents and profits, it is clear *** that the mortgagor's trustee has no rights as to such rents and profits from the property when bankruptcy ensues." (emphasis supplied). 4A Collier on Bankruptcy (14th ed.) ¶ 70.16 at 159-161 (1976), citing as authority Mortgage Loan Co. v. Livingston, 45 F.2d 28 (8th Cir. 1930); New Orleans Compress, Inc. v. Katz, 185 La. 723, 170 So. 244 (1936); Central States Life Ins. Co. v. Carlson, 98 F.2d 102 (10th Cir. 1938); First Savings

Bank v. Stuppi, 2 F.2d 822 (8th Cir. 1924).

If a Chapter XI proceeding is not part of bankruptcy, then in this case, actions taken during the Chapter XI proceeding were performed prior to bankruptcy and would thus establish the mortgagee's right to the rents under the above-stated rule.

North Carolina General Statute § 1-502(1) provides as follows:

"A receiver may be appointed, (1) Before judgment on the application of either party, when he establishes an apparent right to property which is the subject of the action and in the possession of an adverse party, and the property or its rents and profits are in danger of being lost, or materially injured or impaired; ***." N.C. Gen. Stat §1-502(1), Vol. 1A, p. 524.

Thus it is clear that before bankruptcy in this case, obtaining the appointment of a receiver would have been acceptable under the state law. For the above reasons petitioner submits that even if the appointment

of a receiver were not obtained "during bankruptcy" the Fourth Circuit committed error in holding that obtaining the receiver's appointment did not establish petitioner's claim to the rents since, if the appointment were not during bankruptcy, it must necessarily have taken place prior to bankruptcy.

VI. The Fourth Circuit Court of Appeals in its decision so far departed from the accepted and usual course of judicial proceedings as to call for and exercise of the Supreme Court's power of supervision under U.S. Sup. Ct. Rule 19(1)(b), 28 U.S.C.

There is an inescapable contradiction in the opinion of the Fourth Circuit Court of Appeals here. On the one hand they rule sub silentio that a Chapter XI proceeding is not a part of the Bankruptcy proceeding insofar as Petitioner is concerned in that Petitioner's actions during the Chapter XI proceeding will not carry over to secure a claim to the rents in the Bankruptcy proceeding. On the other hand, in reinstating

the Order of Bankruptcy Judge Marvin R. Wooten (App. to Pet. for Cert. pp. 2a-20a), they are ruling that, insofar as Respondents are concerned, a Chapter XI proceeding is a part of the Bankruptcy proceeding since that Order allowed priority to claims arising out of the Chapter XI proceeding. The order of Judge Wooten awarded without exception attorney fees and accountant's fees generated as a result of work done during the Chapter XI proceeding.

The nature of the relationship between Chapter XI and straight bankruptcy cannot fluctuate depending on whose rights are involved. The same interpretation of the relationship must be applied both to the above claimants and to the Petitioner.

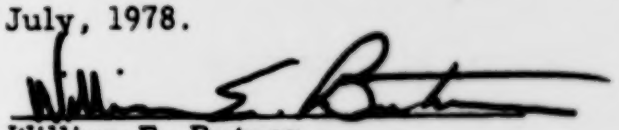
This contradiction in the opinion of the Fourth Circuit Court of Appeals is obvious and cannot be resolved. Thus the United States Supreme Court should, by virtue of its supervisory power over the lower Federal courts pursuant to Supreme Court rule 19(1)(b), re-

move this contradiction. 28 U.S.C. Appendix--Rule of the Supreme Court 19(1)(b) p. 7686.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the judgment of the Fourth Circuit Court of Appeals should be reversed and the cause be remanded to the Bankruptcy Court for implementation of the judgment of the United States District Court.

This the 19th day of July, 1978.



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